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No. 97-147

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

ATLANTIC MUTUAL INSURANCE CO.
AND INCLUDIBLE SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
for the Third Circuit**

BRIEF *AMICI CURIAE* OF AMERICAN INSURANCE ASSOCIATION, ALLIANCE OF AMERICAN INSURERS, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES, AND REINSURANCE ASSOCIATION OF AMERICA IN SUPPORT OF PETITIONER

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This brief in support of petitioner is submitted with the written consent of counsel for petitioner and the Solicitor General filed with the Clerk of the Court.[1]

[1] This brief was not authored in whole or in part by counsel for a party to this proceeding, and no person or entity, other than the *amici curiae*, their members, or their counsel, made a monetary

INTEREST OF THE *AMICI CURIAE*

The American Insurance Association, the Alliance of American Insurers, the National Association of Independent Insurers, the National Association of Mutual Insurance Companies, and the Reinsurance Association of America are the five leading associations of property and casualty insurers and reinsurers in the United States. Their members, comprised of over 2,000 insurance and reinsurance companies, write nearly 85 percent of the property and casualty insurance underwritten in the U.S. (including over $223 billion in direct premiums written in 1996), and substantially all of the property and casualty reinsurance assumed by U.S. companies on U.S. risks, and range in size from small companies that operate in a single state to the largest insurers with global operations. These companies are subject to the loss reserve discounting provisions of the Tax Reform Act of 1986, which include transition rules known as the "fresh start."

All five associations regularly file *amicus curiae* briefs in cases that have a significant impact on their member companies. In this case, the *amici* and their members believe that the United States Court of Appeals for the Third Circuit erred in upholding a regulation by which the Internal Revenue Service implemented a statutory limitation, referred to as "reserve strengthening," on the fresh start transition rules. If this decision is upheld, the insurance industry represented by these associations will suffer a severe financial burden, imposed in a capricious and inequitable manner on individual companies within that industry, that could not have been intended by Congress.

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contribution to the preparation or submission of this brief. The petitioner is a member of *amici* Alliance of American Insurers and National Association of Mutual Insurance Companies, but has not made a monetary contribution to the preparation or submission of this brief beyond that of other members of those *amici*.

SUMMARY OF ARGUMENT

In order to prevent abuse of the fresh start rules applicable to insurers and reinsurers transitioning to the loss reserve discounting provisions of the Tax Reform Act of 1986. Congress provided that certain types of "artificial" additions made in 1986 to loss reserves were to be denied the otherwise-available fresh start. Congress did not deny the fresh start to all reserve additions made in 1986, but only to those that resulted from "reserve strengthening." In Treasury Regulation § 1.846-3(c), under the guise of interpreting the statute, the IRS has taken a blunderbuss regulatory approach—transgressing the plain meaning and intent of the statute—to implement this narrow, tax-avoidance safeguard.

Atlantic Mutual contends that, by using the statutory term "reserve strengthening," Congress intended to deny the fresh start *only* to reserve increases resulting from a company's change in the assumptions or methodologies used to calculate loss reserves. The *amici* agree that the IRS's regulation is invalid because it conflicts with Congress' intent as evidenced by the plain and unambiguous language of the statute. The *amici* also contend that the IRS's regulation is invalid because it imposes an avowed "two wrongs make a right" approach, which conflicts with Congress's intent as evidenced by the legislative history of the statute. By perversely disallowing the fresh start with respect to virtually all nonartificial, or natural, reserve increases, and allowing it with respect to certain artificial reserve increases, this approach grossly and inequitably distorts the fresh start and arbitrarily impacts taxpayers in this industry in a manner that could not have been intended by Congress.

The legislative history confirms that Congress's purpose was to deny the fresh start to reserve additions attributable to changes in reserve assumptions and methodologies. Congress considered such reserve additions artificial and thus abusive. The IRS regulation, however, is sweeping and

indiscriminate in its scope, and denies the fresh start not only to artificial reserve additions attributable to changes in reserve assumptions and methodologies, but also to nonartificial reserve increases that occurred naturally under preexisting and unchanged reserve assumptions and methodologies. Indeed, the regulation is so overbroad and irrational that it denies the fresh start in some instances where there was no reserve increase whatsoever, and allows the fresh start in others where a reserve increase was admittedly artificial. The regulation is in conflict with the legislative history, which reflects a far more limited intent, and disregards the fact that Congress had no intent to deny the fresh start to nonartificial reserve increases not attributable to changes in assumptions and methodologies. Because the regulation is fundamentally at odds with the congressional mandate, this Court should hold the regulation invalid.

Under the "plain language" principle advanced by Atlantic Mutual and supported by the *amici,* Atlantic Mutual is entitled to prevail, because the government admits that Atlantic Mutual did not change its reserve assumptions or methodologies. Under the "legislative history" analysis in this *amici* brief, Atlantic Mutual also is entitled to prevail, because the government admits that Atlantic Mutual did not artificially increase any reserves. Atlantic Mutual, and the many companies represented by the *amici* with a stake in this issue, would have $1 billion of their fresh start adjustments taken away under the regulation's irrational mechanical rule for determining reserve strengthening.

ARGUMENT

I. THE *AMICI* AGREE WITH ATLANTIC MUTUAL THAT THE IRS REGULATION CONFLICTS WITH THE PLAIN LANGUAGE OF THE RESERVE STRENGTHENING SAFEGUARD IN THE STATUTE, AND ALSO CONTEND THAT THE REGULATION IS INVALID BECAUSE IT FAILS TO IMPLEMENT THE CONGRESSIONAL MANDATE IN A REASONABLE MANNER

This case involves the application of settled principles of statutory interpretation. Atlantic Mutual demonstrates that the language of the statute is clear from Congress's use of the term "reserve strengthening" and, thus, that it is entitled to prevail without further analysis of legislative history. We concur with Atlantic Mutual and do not further address the argument based on the plain language of the reserve strengthening provision.

The government contends (Res. Br. 15) that its position "draws substantial support from the legislative history of the statute." This brief demonstrates the opposite—that if resort is had to the legislative history, the IRS's interpretation of the statute is based on a impermissible contruction of the reserve strengthening provision, which has arbitrary impacts on affected insurers, and is invalid for this reason as well. In this regard, this Court has repeatedly made clear that, in order for an agency regulation to be accorded deference, it is not sufficient for the government to maintain that the words of the statute can conceivably bear the meaning the agency would ascribe to them. It is necessary in addition that the regulation "implement the congressional mandate in some reasonable manner." ***Commissioner v. Engle,*** 464 U.S. 206, 224 (1984) (quoting ***United States v. Correll,*** 389 U.S. 299, 307 (1967) (internal quotation marks omitted)); ***National Muffler Dealers Ass'n v. United States,*** 440 U.S. 472, 476-77 (1979) (quoting ***United States v. Cartwright,*** 411 U.S. 546, 550 (1973), in turn quoting ***United States***

v. Correll, 389 U.S. 299, 307 (1967) (internal quotation marks omitted)).

The regulation at issue here not only fails to implement Congress's intent in a reasonable manner; it actually conflicts with the congressional mandate. The legislative history shows that Congress's purpose was to deny the fresh start to artificial reserve additions attributable to changes in the assumptions and methodologies used to establish reserves. The legislative history belies any intent to deny the fresh start to nonartificial reserve increases that occurred naturally under existing and unchanged reserve assumptions and methodologies. The gross over-inclusiveness of the IRS's regulation obliterates the distinction between artificial and nonartificial reserve increases that was at the heart of the limitation placed on the fresh start, producing absurd and arbitrary results that Congress could not have intended. For these reasons, discussed in detail below, the regulation should be held invalid.

II. THE TREASURY REGULATION AT ISSUE FAILS TO HARMONIZE WITH THE ARTICULATED PURPOSE OF THE STATUTE

In section 1023(c) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2399 (1986) (the "1986 Act"), Congress required that, beginning with the year 1987, property and casualty insurers and reinsurers [2] apply a present value methodology to discount their unpaid loss reserves. For purposes of 1987 tax computations, section 1023(e)(2) of the 1986 Act permits insurers to use discounted year-end 1986 reserves. General change-in-method-of-accounting principles ordinarily would require the inclusion in income of the difference between the undiscounted and discounted year-end 1986 reserves. To mitigate the transitional impacts of discounting, how-

[2] In this brief, unless the context indicates otherwise, the term "insurers" is used to refer to both insurers and reinsurers.

ever, Congress provided a fresh start that excludes this difference from taxable income.[3] 1986 Act, § 1023(e)(3)(A), 100 Stat. at 2404.

Congress also enacted a reserve strengthening safeguard in section 1023(e)(3)(B) of the 1986 Act out of concern that insurers could increase their fresh start adjustment by artificially inflating reserves in 1986.[4] As explained in the legislative history, this anti-abuse "provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-367 (1986) (hereinafter the "Conference Report").[5] To achieve this intended result, Congress specified in the statute that the "[fresh start provision] shall not apply to any reserve strengthening" occurring during the year 1986.

In Treasury Regulation § 1.846-3(c), an interpretative regulation issued to implement section 1023, the IRS prescribed a so-called "mechanical test" that broadly and arbitrarily denies the fresh start.[6] T.D. 8433, 1992-2 C.B. 146. The regulation denies the fresh start not only to artificial reserve additions attributable to changed reserve assumptions and methodologies, as Congress clearly intended, but also to virtually all nonartificial reserve increases that occurred naturally under existing reserve as-

[3] Just two years earlier, Congress had provided a "fresh start" with respect to significant changes in the way in which insurance companies calculate life insurance reserves for federal income tax purposes. Deficit Reduction Act of 1984, § 216, Pub. L. No. 98-369, 98 Stat. 494, 758 (1984) ("DEFRA").

[4] Congress similarly had included a "reserve strengthening" safeguard on the fresh start it had provided for insurers in DEFRA two years earlier. DEFRA, § 216, 98 Stat. at 758.

[5] For the convenience of the Court, we have reproduced the relevant portion of the Conference Report in the Appendix.

[6] The regulation contains limited exceptions, addressed to narrow circumstances, that are not relevant here.

sumptions and methodologies. The regulation is so overbroad that it also operates to deny the fresh start even in some cases where reserves were not increased at all. On the other hand, the regulation perversely allows the fresh start in other cases despite the existence of an artificial reserve increase.

Property and casualty insurers, in the ordinary course of their business, must establish and periodically adjust loss reserves in order to fulfill their obligations to policyholders.[7] Here, the government admits (Pet. 4-5) that Atlantic Mutual's reserves were both reasonable in amount and the natural result of the consistent application of Atlantic Mutual's preexisting reserve assumptions and methodologies. Indeed, the government stipulated (Pet. 4-5) that Atlantic Mutual took no action in 1986 with respect to its reserves that was tax motivated. Yet, the government seeks to enforce the IRS regulation, which, in this instance, mechanically denies a significant portion of the fresh start to Atlantic Mutual.

A. The Regulation Is Fundamentally at Odds with Congress's Purpose of Denying the Fresh Start to Artificial Reserve Additions

The statutory language at issue had its origin in a Senate bill. H.R. 3838, 99th Cong., 2d Sess., § 1022(e) (as reported by the Senate Finance Committee, May 29, 1986) (hereinafter the "Senate bill"). Insofar as relevant here, the Senate bill provided that the "[fresh start provision] shall not apply to any reserve strengthening."

The parties are in agreement that the Senate bill used the term "reserve strengthening" to refer only to reserve additions resulting from changes in reserve assumptions or methodologies. The Senate bill thus allowed the fresh start to insurers that continued to follow their existing reserve assumptions and methodologies. The accompany-

[7] Similarly, reinsurers must establish and periodically adjust loss reserves in order to fulfill their obligations to insurers.

ing Senate report is fully consistent with the text of the Senate bill. The report expresses the Senate's intent to deny the fresh start to reserve increases "attributable to changes in reserves on account of changes in the basis for computing reserves (i.e., reserve strengthening . . .)." S. Rep. No. 313, 99th Cong., 2d Sess. 510 (1986) (hereinafter the "Senate Report").

The term "changes in the basis for computing reserves," as used in the Senate Report, has a well established meaning in the insurance industry. The term encompasses only reserve additions that result from a change in the assumptions or methodologies used in calculating reserves.[8] In contrast, the term excludes reserve additions that are not attributable to a change in assumptions or methodologies, but that occur naturally as the insurer continues to follow and apply its existing reserve assumptions and methodologies.[9]

The government admits (Res. Br. at 4) that the Senate bill "limited [the term] reserve strengthening to changes

[8] A "change in basis" is a specialized type of "change in method of accounting," which is a term the IRS has defined in regulations issued under Internal Revenue Code section 446. In discussing the life insurance provisions of the Code, upon which the Senate bill was based, the IRS has acknowledged that "the term 'basis' is used interchangeably with 'method' when describing the effects of a change in basis of computing reserves." Rev. Rul. 94-74, 1994-2 C.B. 157, 159. *See American Gen. Life & Accident Ins. Co. v. United States*, 90-1 U.S.T.C. (CCH) ¶ 50,010, at 83,042 (M.D. Tenn. 1989) (a "change in basis" is a "type of 'change in method of accounting' ").

[9] For example, changes in accounting method do not include the "correction of mathematical or posting errors." Treas. Reg. § 1.446-1(e)(2)(ii)(b). The IRS has ruled that "consistent with section 446, the correction of reserves for a mathematical or posting error would not be treated as a change in basis . . . ." Rev. Rul. 94-74, 1994-2 C.B. at 160. Likewise, changes in accounting method do not include "a change in treatment resulting from a change in underlying facts." Treas. Reg. § 1.446-1(e)(2)(ii)(b). A reserve addition attributable to changed facts similarly is not a change in basis of computing reserves.

in reserve practices." The government thus agrees (Res. Br. at 15) that the Senate bill denied the fresh start only to reserve increases attributable to "changes in reserve methodologies."

In denying the fresh start in the case of changes in reserve assumptions and methodologies (*i.e.*, "reserve strengthening"), the Senate bill reflected an obvious intent. As the court below explained (Pet. App. A5):

> Congress anticipated . . . the potential for abuse created by the fresh start provision—that insurers could manipulate the fresh start provision by inflating their reserves. To prevent abuse, Congress enacted section 1023(e)(3)(B) to exclude any increases in loss reserves due to "reserve strengthening."

As the subsequent Conference Report expressly stated, "[the statutory] provision is intended to prevent taxpayers from *artificially* increasing the amount of income that is forgiven under the fresh start provision." Conference Report at II-367 (Appendix) (emphasis added).

Under existing reserve assumptions and methodologies, reserve adjustments (both increases and decreases) occur naturally, for example as a reserve methodology responds to changes in facts or law. By contrast, a "change in basis" occurs only when there is a departure from existing reserve assumptions or methodologies, and it is within an insurer's discretion or control whether to make such a departure. The Senate bill reflected the concern that an insurer could abuse the fresh start by changing its basis for computing reserves in 1986. Accordingly, the Senate bill treated any "change in basis" occurring in 1986 as an artificial manipulation intended to take advantage of the fresh start.

The conference committee included in the conference bill the same term used in the Senate bill—"reserve strengthening"—which the parties agree applies only to "changes in basis." In its report, the conference committee emphasized that its intent was to deny the fresh start

to artificial reserve increases. In accordance with this intent, the Conference Report provided that, for purposes of denying the fresh start, the term reserve strengthening should be "considered to include" three categories of artificial reserve increases. As described below, analysis of the Conference Report confirms that the committee's purpose was to deny the fresh start to reserve increases attributable to changes in reserve assumptions or methodologies.

Preliminarily, it is important to note that the conference committee did not provide for all reserve increases to be denied the fresh start (as the IRS's regulation seeks to do). The conference bill denied the fresh start only to "reserve strengthening," thus employing the same terminology as the Senate bill, and the Conference Report confirmed the intent to cover only "reserve strengthening additions," not all reserve additions. Conference Report at II-367 (Appendix). Importantly, the Conference Report carefully prescribed the limited goal of "prevent[ing] taxpayers from *artificially* increasing" reserves, and thereby increasing the amount of income forgiven under the fresh start. *Id.* (Appendix) (emphasis added).[10] Consistently, the Conference Report states that the fresh start should be denied, not to all reserve increases, but only to specific categories of reserve increases. This legislative history is wholly inconsistent with the IRS's regulation, which extends indiscriminately to essentially all nonartificial reserve increases, and then fails to capture all artificial increases.

The first two categories of reserve increases mentioned in the Conference Report relate to changes in reserve assumptions and methodologies. In the first category, the

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[10] This intent to deny the fresh start to artificial reserve additions was reemphasized in the "Bluebook" prepared for the Tax Reform Act of 1986. Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986* 618 (Jt. Comm. Print 1987).

Conference Report reaffirms the Senate's decision that traditional reserve strengthening, *i.e.*, changes in basis, should be denied the fresh start. The Conference Report provides that "reserve strengthening" includes "all additions to reserves attributable to an increase in an estimate of a reserve established for a prior [pre-1986] accident year." Conference Report at II-367 (Appendix). This category applies to reserve estimates that insurers held as of year-end 1985. As described above, insurers had determined those reserve estimates by applying reserve methodologies based on particular assumptions. The conference committee proceeded on the assumption that if, in reporting its reserve estimates for 1986, an insurer simply continued to utilize existing reserve assumptions and methodologies, there would be no increase in a reserve estimate and no change in basis. On this assumption, mere increases in 1986 reserves over 1985 reserves that occurred naturally under an existing methodology, and not as the result of a change in reserve assumptions or methodologies, would not be changes in basis and would not be denied the fresh start.[11]

In the second category, the Conference Report states that "reserve strengthening" also should be considered to include "additions to reserves resulting from a change in the assumptions . . . used in estimating losses for the 1986 accident year." *Id.* This category applies to reserve estimates first established during 1986. Because these reserve estimates did not exist at year-end 1985, reserve strengthening cannot be determined under the category one method of comparing the year-end 1986 reserve estimates to year-end 1985 reserve estimates. Instead, it is necessary

[11] Any reserve held at year-end 1985 was eliminated during 1986 if the related claim was paid in 1986. To account for this, the Conference Report states that, when comparing year-end 1985 reserve estimates and year-end 1986 reserve estimates, the year-end 1985 reserve estimates must be reduced to "tak[e] into account claims paid [during 1986] . . . ." Conference Report at II-367 (Appendix).

to determine whether the insurer, in establishing the reserve estimates in 1986, used the same reserve assumptions and methodologies that it would have used had it established the reserve estimates in 1985.[12] The conference committee intended that insurers be permitted to establish new reserve estimates during 1986 using their existing reserve assumptions and methodologies, and intended to deny the fresh start only if there was a change in the prior assumptions and methodologies.

As the third category, the Conference Report denies the fresh start to "all unspecified or unallocated additions to loss reserves." Conference Report at II-367 (Appendix). The scope of this category is unclear, because property and casualty insurers are required to identify additions to their reserves and to allocate reserves to particular lines of business and accident years. This category seems to encompass only reserve additions attributable to unspecified reasons outside the existing reserve methodology and unrelated to facts relevant under the existing reserve methodology. Whatever this category's limited scope, it clearly does not include reserve increases that occurred naturally under preexisting reserve assumptions and methodologies, and provides no support for the IRS's regulation which denies the fresh start to all nonartificial reserve additions.

If the legislative history is to be read harmoniously, the first category described above must be interpreted to cover only changes in the assumptions or methodologies used to determine existing reserves for pre-1986 accident years. In the language describing the second category of reserve increases denied the fresh start, which immediately follows the language describing the first category, the Con-

[12] The IRS's regulation requires that insurers compute a "hypothetical" year-end 1985 reserve "computed using the same assumptions . . . that were used to determine the 1985 accident year reserve, if any, for the line of business for which the hypothetical reserve is being computed." Treas. Reg. § 1.846-3(c)(2)(ii).

ference Report refers to "additions to reserves *resulting from a change in the assumptions . . . used in estimating losses* for the 1986 accident year." Conference Report at II-367 (Appendix) (emphasis added). This language reflects the conference committee's view that assumptions and methodologies are used to determine reserve estimates.[13] Thus, by describing the first category of reserve increases to be denied the fresh start as those "attributable to an increase in an estimate of a reserve," the conference committee was referring to "an increase in an estimate . . . resulting from a change in the assumptions" used to establish that estimate.

The government contends that by using the language "all additions to reserves attributable to an increase in an estimate of a reserve," the conference committee intended the first category to include "all additions to reserves." Of course if this were true, the conference committee would not have found it necessary to add the limiting language "attributable to an increase in an estimate of a reserve" that immediately follows "all additions to reserves." Under the government's approach, that limiting language is meaningless surplusage. Likewise, under the government's approach, there was no need for the conference committee to separately deny the fresh start to the third category of reserve increases—"all unspecified or unallocated additions to loss reserves." If the government were correct that the first category encompasses all reserve increases, the conference committee had no need to provide for this third category, and the Conference Report language doing so also is meaningless surplusage.

[13] The IRS shares this view. As described in note 12, *supra*, Treasury Regulation § 1.846-3(c)(2) requires that insurers compute a "hypothetical" 1985 reserve estimate with respect to the 1986 accident year "using the same assumptions" used to compute 1985 reserve estimates. It would be impossible for an insurer to compute such a "hypothetical" reserve estimate unless the insurer computed its loss reserves by consistently applying specific reserve assumptions and methodologies.

Perhaps most telling is that in describing what reserve increases were to be denied the fresh start, the conference committee was careful to state that its intent was to reach *artificial* increases. If the government were correct that the conference committee intended that its anti-abuse provision deny the fresh start to *all* reserve increases—without regard to their artificiality—then the Conference Report's statement that the provision was intended to reach artificial reserve increases is inconsistent and contradictory. Indeed, when the IRS announced its regulation in final form, and quoted the Conference Report, it omitted the conference committee's statement that it intended to deny the fresh start to artificial reserve increases, presumably because it was unable to reconcile its regulation with the conference committee's expressed intent. T.D. 8433, 1992-2 C.B. 146. In the end, the government's contentions with respect to the Conference Report are unpersuasive.[14]

The IRS's regulation expands the scope of fresh start denial beyond artificial reserve additions attributable to changes in assumptions and methodologies to include non-artificial increases occurring under preexisting assumptions and methodologies. Such natural reserve increases are required in order for an insurer to meet its obligations to pay the claims of its policyholders. Such increases are not abusive, and Congress did not intend its anti-abuse rule to deny these increases the fresh start. Nor is there any reason to do so. Because the IRS's regulation is at

[14] In his memorandum opinion below, Tax Court Judge Foley implied (Pet. App. A41) that in *Western Nat'l Mut. Ins. Co. v. Commissioner*, 102 T.C. 338 (1994), *aff'd*, 65 F.3d 90 (8th Cir. 1995), the Tax Court found the IRS's regulation to be "consistent with" the Conference Report. Judge Foley misinterpreted *Western National*. While the Tax Court did state that some support "can be found in the legislative history" for the regulation, the Tax Court expressly held (102 T.C. at 355) that the legislative history "provides no persuasive rationale" for the government's position and declared the regulation contrary to Congress's intent and therefore invalid.

odds with Congress's clearly expressed purpose to cover artificial reserve additions, this Court should hold the regulation invalid.

B. The Regulation Implements the Statute in an Arbitrary and Unreasonable Manner

The IRS regulation conflicts with Congress's intent not only because it seeks to deny the fresh start to non-artificial reserve increases, but also because it imposes a mechanical test that operates in an arbitrary and capricious manner that Congress could not have intended. As explained below, the regulation perversely denies the fresh start in situations not intended by Congress and allows the fresh start in other cases not intended by Congress.

The mechanical test operates erroneously and absurdly by creating "phantom" reserve strengthening when none actually exists. For example, assume that an insurer transferred a risk to a reinsurer, that the reinsurer established a reasonable $50,000 reserve for that risk, and that the insurer was permitted to eliminate its own $50,000 reserve for the risk. If the reinsurer encountered financial difficulties during 1986—as occurred in a number of instances—the insurer itself was required to reinstate the $50,000 reserve that it previously had been permitted to eliminate because of the reinsurance. In this situation, actually faced by member companies of the *amici*, the IRS's mechanical test creates $50,000 of "phantom" reserve strengthening for the insurer, despite the fact that no reserve strengthening actually occurred.

Another situation, frequently faced by member companies of the *amici* during 1986, involves claims that were closed in years before 1986, but which had to be reopened in 1986 by reason of the disclosure to the insurers of previously unknown facts. Upon the reopening of these claims in 1986, the insurers were required to set up loss reserves. In these situations, the IRS's mechanical test also creates "phantom" reserve strengthening.

There are many other instances, commonly faced by member companies of the *amici*, where application of the regulation's mechanical rule finds reserve strengthening, even though there is no possibility of any reserve increase. To illustrate, assume that an insurer established four loss reserves of $500 each, for a total of $2,000. In the following year, assume that the insurer paid two of the four claims for which the reserves were held for $750 each, for a total of $1,500, and continued to maintain the two $500 reserves for the unpaid claims. On these facts, the regulation's mechanical test creates $500 of "phantom" reserve strengthening (after payments of $1,500 were made with respect to year one reserves of $2,000, year two reserves were not $500, but rather $1,000). Yet, no actual reserve strengthening occurred. The insurer did not increase (but rather decreased) its reserves, but the IRS's mechanical test nevertheless creates "phantom" reserve strengthening based solely on the amounts of the claim payments that the insurer made to policyholders.

The IRS's regulation also would erroneously disallow fresh start in cases where actual 1986 reserve increases were made attributable to changes in law (statutory, regulatory or judicial) or the correction of an error in determining reserves for a prior year. These are not merely hypothetical situations; many member companies of the *amici* made such reserve additions during 1986.

The IRS acknowledges that its mechanical test "does not take into account" the situations described above, and thus will result in the "erroneous inclusion" of "certain amounts in the computation of reserve strengthening . . . ." Prop. Treas. Reg. § 1.846-3, 56 Fed. Reg. 20,161, 20,162 (1991) (Preamble). The IRS freely admits—in what is surely the epitome of understatement—that under the regulation there is "the absence of total accuracy." This inaccuracy, while unjust, is not by itself dispositive, because there is no requirement that regulations achieve perfect results. The key point is that by irrationally creat-

ing "phantom" strengthening, the regulation operates in a manner that Congress could not have intended.

The government attempts to justify its mechanical test by asserting that the "inaccuracies are likely to offset each other in the aggregate." 56 Fed. Reg. at 20,162. Rather than take this "two wrongs make a right" approach, a proper regulation would implement the rule that Congress actually adopted. Moreover, there is no support for the government's assertion that the inaccuracies caused by the test are likely to even out.

For an insurer that ultimately paid losses on claims in amounts that were greater than its reserves for those claims (as in the immediately preceding example), the regulation unfairly creates substantial amounts of "phantom" reserve strengthening. On the other hand, consider an insurer that ultimately paid losses on claims in amounts that were less than its reserves for those claims. For example, assume that an insurer established four reserves in year one of $500 each (for a total of $2,000), and then paid $250 apiece with respect to two of the four claims in year two ($500 total), while maintaining the two $500 reserves for the unpaid claims. The mechanical test detects "phantom" reserve weakening of $500 (after making payments of $500 with respect to year one reserves of $2,000, year two reserves were not $1,500, but rather $1,000). Thus, on facts where neither insurer has strengthened reserves, but simply paid different amounts of losses, the regulation unfairly denies the fresh start to the insurer whose paid losses were greater than its reserves, but not to the insurer whose paid losses were less than its reserves. Moreover, suppose the latter insurer artificially changed its reserve methodologies to increase its remaining year two reserves from $500 each to $750 each (for a total of $1,500). The IRS's mechanical test would not detect this actual reserve strengthening and, contrary to Congress' intent, would not deny any of the fresh start.[15] Simply put, the IRS's mechanical test is absurd and unjustified.

Addressing these types of distortions resulting from the application of the IRS's regulation, the Third Circuit stated (Pet. App. A23-A24) that if the test is flawed, taxpayer's recourse is to Congress, and not the courts, and that the courts must focus, not on the "Act's policy," but rather on what Congress intended in enacting it. The *amici* agree, but disagree that these points weigh in favor of the government. The test that is flawed is the IRS's blunderbuss regulation, not the focused reserve strengthening safeguard provided for by Congress in the 1986 Act. Moreover, the *amici* do not object to the "Act's policy," but rather to the conclusion that the inequitable and grossly distorted effects in the insurance industry resulting from the IRS's regulation could have been intended by Congress.

As a last refuge, the government contends that the regulation can be defended on the ground that it "avoids significant compliance and administrative burdens." Prop. Treas. Reg. § 1.846-3, 56 Fed. Reg. at 20,162 (1991) (Preamble). This is little more than *ipse dixit* which the IRS has never even attempted to quantify or substantiate. In any event, this Court should not allow the IRS to impose a substantial tax burden that Congress did not intend solely on the ground of administrative convenience.

Moreover, because the statute requires a determination of reserve strengthening for only one year (1986), whatever burden exists cannot be considered significant. In this regard, it is important to note that, with respect to reserves for the 1986 accident year (category two), the regulation requires the determination of a hypothetical 1985 reserve using the same reserve assumptions actually used to determine 1985 reserves. Treas. Reg. § 1.846-3(c)(2). Once

[15] The government's argument that the mechanical test must be overly broad in order to reach all artificial abuses is thus incorrect.

those 1985 reserve assumptions are determined, it would impose little additional burden to determine whether those reserve assumptions were used without change to determine 1986 reserves for pre-1986 accident years (category one). Thus, the government's administrative burden argument is spurious.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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APPENDIX

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. at II-367 (1986).

* * * * *

Fresh start adjustment

The conference agreement follows the Senate amendment with respect to providing a fresh start adjustment—i.e., a forgiveness of income—for the reduction in reserves resulting from discounting the opening reserves in the first post-effective date taxable year of the provision. The conference agreement modifies the Senate amendment with respect to the treatment of reserve strengthening under the fresh start income forgiveness provision. Under the conference agreement, reserve strengthening in taxable years beginning after December 31, 1985, is not treated as a reserve amount for purposes of determining the amount of the fresh start. Instead, such reserve strengthening additions to loss reserves in taxable years beginning in 1986 are treated as changes to reserves in taxable years beginning in 1987, and are subject to discounting. Reserve strengthening is considered to include all additions to reserves attributable to an increase in an estimate of a reserve established for a prior accident year (taking into account claims paid with respect to that accident year), and all additions to reserves resulting from a change in the assumptions (other than changes in assumed interest rates applicable to reserves for the 1986 accident year) used in estimating losses for the 1986 accident year, as well as all unspecified or unallocated additions to loss reserves. This provision is intended to prevent taxpayers from artificially increasing the amount of income that is forgiven under the fresh start provision.

The amount of the fresh start forgiveness of income is included in earnings and profits for the taxpayer's first taxable year beginning after December 31, 1986.

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